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# The Mexican Financial System: Toward a German Universal Banking Model? A Comparative Analysis

*Miguel Angel Garza C.<sup>1</sup>*

## Introduction.

Recent years have witnessed a dramatic change and transformation in the financial systems of the world as a consequence of the appearance of new products, services, and intermediaries, as well as the growing deregulation prevailing in many countries. Accordingly, financial structures have been forced to adapt these changes.

Universal banking, one of the main products of the deregulation process, represents a feasible alternative to the existing financial system structures of many nations and is already followed by a large number of nations around the world. A growing tendency, for example, is for banking institutions to shift from their core business (deposit taking and lending) over to securities operations. Depending on the particular circumstances of each country, the universal banking option allows for more efficient systems by means of reducing the operative costs of intermediaries through the performance of different financial services within the same entity or organization. A universal banking model ranges from offering all financial services through the same organization or group with different entities (e.g., the Mexican system) to the possibility of a single institution performing different financial services (e.g., the German Banking System).

Mexico is not an exception to the worldwide process of the transformation and development of financial systems. First, in 1990, with the reacquisition of the banking system by the private sector, the issuance of new laws, and then, in 1994, with the "opening" of the financial system to the foreign participation under the North American Free Trade Agreement (NAFTA), Mexico has been fully involved in this transformation process.

The purpose of this article is to outline the advantages and disadvantages of two main streams of universal banking for Mexico: the German approach, in which a bank as a single entity is allowed not only to perform all types of banking and securities activities, but also to invest in the capital of nonfinancial companies; and the English model, in which banks own directly, and not through a holding company, all types of financial intermedi-

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aries. In either case, the universal banking model considered as an option should be limited to banking and securities issues, since insurance and bonding businesses are of a completely different legal and accounting nature. Likewise, it is important to bear in mind that other minor financial services such as financial leasing and factoring and money exchange are already legally permitted in the Mexican banking institutions, and thus no reference will be made to the integration of these activities into a universal banking system.

Perhaps the most important aspect of this analysis will be the consideration it gives to the implementation of universal banking in Mexico. This statement does not suggest that the implementation of the universal banking system will necessitate or facilitate the disappearance of securities firms; such implementation merely suggests the merger of banking and securities activities within the same entity for those banks that consider such a merger convenient or economically advisable. Of course, the option would represent a consolidation of the financial intermediaries due to the economies of scale and a reduction in the costs involved.

The first section of this article analyzes the Mexican Financial System in order to understand its legal and economic foundations and thus the feasibility for the implementation of a universal banking model. Thereafter, section two reviews the German and English financial systems, the first as the model of universal banking to follow, the second as a "de facto" universal banking system. Finally, section three proposes a new regulatory regime for Mexico, reviewing the advantages and disadvantages of a universal banking model for the country and examining the role Mexican regulatory and supervisory authorities would have to play in order to adequately monitor the new system.

## I. The Mexican Financial System.

### A. HISTORY AND DEVELOPMENT.

The history and development of the Mexican Financial System (MFS) is inevitably linked to the history of its banking. Although Mexico has a very complete and comprehensive financial system capable of offering all types and ranges of financial services, the most important part of the Mexican system is the banking industry. Therefore, for purposes of this study references to the MFS will emphasize banking activities.

The MFS is currently characterized by an active process of transformation<sup>2</sup> in which the participation of new intermediaries and the development of new products and services are key features in a growing global context. This section briefly deals with the history and development of the MFS, reviewing its current legal status and the impact of the NAFTA on it, as well as the consequences and the importance of the financial crisis beginning in December of 1994.

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2. See MIGUEL ACOSTA ROMERO, *NUEVO DERECHO BANCARIO, PANORAMA DEL SISTEMA FINANCIERO MEXICANO* 16 (1995).

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1. *History and Development of the Mexican Banking System Before the 1970s.*

- a. Prior to Independence

Recognition of any type of formal banking in Mexico before independence was achieved is difficult. The few institutions that were created by the Spanish (e.g., Banco de Avío de Minas) were aimed at supporting, in a limited way, certain strategic activities in the New Spain, such as mining and agriculture.

- b. Independence Period until 1910.

This period in Mexican history was characterized by great confusion and political chaos without a complete and duly structured legal system. As a consequence, and because of the relative inexperience of the new society, no developments in banking or in credit activities took place, since these transactions were practiced by the same traders of the Colonial period.<sup>3</sup> In 1883 the Political Constitution of 1857 was amended in order to reserve the banking regulation, and thus, banking concessions, to the Federal Congress. In 1884 the Commerce Code, considered the first federal law regulating the banking activity, was issued, and firmly established that banking institutions were subject to the prior concession to the competent federal authorities.

In 1897 the Mexican Government issued the first General Law of Credit Institutions, which established four types of banking institutions: issuance banks; mortgage banks; credit banks; and general deposit warehouses.

With the Mexican Revolution of 1910, many of the existing banking institutions went broke because of the indiscriminate granting of credits to the different revolutionary governments; these credits forced the institutions to issue unsecured notes.<sup>4</sup>

- c. The Period Between 1917 and 1970.

In 1915 the financial condition of most of the banking institutions was chaotic, and many institutions were forced to close. In 1917 the current Political Constitution was issued, and established that the issuance of notes and coins, as well as the regulation of banking and credit activities, were the exclusive faculties of the federal state through its Central Bank.

The National Banking Commission was created in 1924, and in 1925 a new General Law of Credit Institutions and Banking Establishments was issued, as well as the Law of the Bank of Mexico. The latter established the legal foundations for the creation of the Bank of Mexico (Mexico's Central Bank). In the following years, the Mexican Government issued the Banking Law of 1932, which reaffirmed the principle of specialization estab-

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3. *See id.* at 53.

4. *See id.* at 60.

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lished by the previous laws, through which a banking institution could only conduct activities expressly allowed in the corresponding concession.<sup>5</sup>

In 1941 a new banking law was issued under the name of General Law of Credit Institutions and Auxiliary Organizations, which was in force until 1982 when the expropriation of banking institutions took place.<sup>6</sup> The banking law of 1941 continued with the principle of banking specialization.<sup>7</sup>

## 2. *History and Development of the Mexican Banking System Between 1970 and 1982.*

Between 1970 and 1982 the MBS experienced one of its most important transformations. At the beginning of 1970, Mexico was dealing with a well-structured financial system, capable of offering a wide range of financial services and products.

In reality, banking specialization was only a concept established by the financial laws, since large financial groups with common shareholders controlled different types of banking institutions, consequently affecting the interests of small independent banking entities that were not allowed to fairly compete with these large organizations.<sup>8</sup> As a repercussion, the Mexican authorities in 1975 promoted an amendment to the Banking Law of 1941 in order to allow a single institution legally to perform the whole range of banking operations and services with the same concession (known as multiple banking).<sup>9</sup>

## 3. *History and Development of the Mexican Banking System Between 1982 and 1990.*

In 1982 the Mexican Government expropriated the commercial banking institutions in the middle of one of the most severe financial and economic crises of Mexico. Between 1982 and 1990 the Mexican authorities issued two banking laws in order to regulate the new, publicly-owned banking institutions. Both laws maintained the principle of multiple banking.<sup>10</sup> For the first time since 1941, the banking laws only regulated the banking insti-

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5. See "Ley general de instituciones de credito," D.O., 27 July 1932 [hereinafter "Mexican Banking Law of 1932"]. In accordance with the Banking Law of 1932 (and its corresponding amendments, especially the one of 1934), the credit institutions are subject to the granting of a governmental concession in order to perform one of the following activities: 1) time and demand deposits; 2) savings deposits; 3) issuance of bonds and time deposit certificates; 4) issuance of mortgage bonds; 5) acting as a fiduciary or trustee; and 6) execution of contracts for the capitalization of savings. *Id.*

6. *Id.*

7. Article 2, paragraph four of the Banking Law of 1941 stated: "the concession cannot be granted to the same entity, in order to carry out more than one of the groups of operations referred to respectively, in the paragraphs I, III, IV and V." Banking Law of 1941.

8. See ROMERO, *supra* note 2, at 422.

9. Article 2 of the Banking Law of 1941 was amended in order to establish that the concessions granted by the Ministry of Finance and Public Credit should be referred to as one or more of the following groups of operation: 1) deposit operations; 2) saving operations; 3) financial operations; 4) mortgage credit operations; 5) capitalization operations; and 6) trust operations. Banking Law of 1941, *supra* note 7.

10. *Id.*

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tutions, leaving the regulation of the auxiliary credit organizations (for example, leasing and factoring companies, credit unions, and money exchange houses) to the Banking Law of 1941 and, since 1985, to the new General Law of Auxiliary Credit Organizations and Activities.<sup>11</sup> In view of the limitations for the participation of private capital in the National Credit Societies, this period witnessed a considerable development of the securities industry as alternative banking.

#### 4. *History and Development of the Mexican Banking System from 1990 to Present Day.*

In 1990 the administration of the former President Carlos Salinas de Gortari decided to return to the mixed regime of banks' ownership. For these purposes, a new Law of Credit Institutions was issued and different constitutional and legal amendments were introduced.<sup>12</sup> Likewise, it is important in this same year a new Law for the Regulation of Financial Groups was issued in order to establish the legal framework for the constitution and the operation of financial groups.<sup>13</sup>

The process of bank reprivatization (reacquisition by the private sector) started in June of 1991 with the sale of Multibanco Mercantil de México and ended in July of 1992 with the sale of Bancen. In total, eighteen banking institutions were resold to private shareholders, and most of these institutions were acquired by the owners of different securities firms.<sup>14</sup>

### B. THE CURRENT MEXICAN FINANCIAL SYSTEM.

#### 1. *Integration of the Mexican Financial System.*

##### a. Regulatory and Supervisory Authorities.

The Ministry of Finance and Public Credit is the authority responsible for the economic and financial policies of the country.<sup>15</sup> It is considered the head of the financial sector, since among its main faculties is the preparation, application, execution, and interpretation of the different financial laws. This authority is also responsible for the granting of authorizations for the incorporation of almost all the financial intermediaries.

Since April of 1994, the Bank of Mexico (Mexico's Central Bank) has been an autonomous entity responsible for the country's monetary and price stability policies.<sup>16</sup> Likewise, the Bank is in charge of the promotion of the sound development of the MFS

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11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. Policies established in general terms, in Article 31 of the Organisational Law of the Federal Public Administration, *infra* note 16.

16. See "Ley reglamentaria del servicio publico de banca y credito," D.O. 14, Jan. 1985, art. 13 [hereinafter "Organizational Law of the Federal Public Administrator"] (establishing policies in general terms). See "Ley del banco de Mexico," D.O., 23 Dec. 1993, arts. 1-2 [hereinafter "Law of the Bank of Mexico"].

and the payment systems. In Mexico, the Central Bank does not have faculties for the supervision of the financial intermediaries, which rely on the supervisory commissions. Finally, the Bank of Mexico is responsible for the administration of the Banking Fund for the Savings' Protection, known as FOBAPROA.<sup>17</sup>

The National Banking and Securities Commission is the result of the merge between the Banking and Securities Commissions in 1995. This Commission is directly responsible for the supervision and regulation of the financial intermediaries under its scope, including banking and securities institutions.<sup>18</sup>

The National Insurance and Bonding Commission is responsible for the supervision and the regulation of the financial intermediaries under its scope, including insurance and bonding companies.

#### b. Financial Intermediaries - Banking Institutions.

Multiple banking institutions are commercial banks and are privately owned. They are allowed to perform any activity specifically established in article 46 of the Law of Credit Institutions, from taking deposits and granting of credits to leasing and factoring operations. These banks may also conduct certain securities operations and may serve as trustees or fiduciaries.

Development banking institutions are institutions created by the government to finance the development of certain economic areas of national interest (e.g., the agricultural and fishing industries). The development banks are incorporated in accordance with their corresponding organizational law, are publicly owned, and are considered National Credit Societies.<sup>19</sup>

Banking affiliates of foreign financial entities are multiple banking institutions that received government authorization for their incorporation in accordance with the corresponding international treaty subscribed to by the Mexican Government (e.g., the NAFTA). At least 51 percent of the equity of these banks must be property of a foreign financial institution, and they are allowed to conduct exactly the same activities as any other domestic entity. The Mexican financial laws allow not only the establishment of banking affiliates, but also any other type of financial intermediaries regulated by corresponding laws.

Limited scope financial companies are the Mexican version of the U.S. non-bank banks. These institutions may not receive deposits from the public. They may grant credits but only for a specific sector or industry of the national economy, and the raising of funds is conducted through bond issues or the reception of credits from other institutions.

#### c. Auxiliary Credit Organizations and Activities

Financial leasing companies' main objective is the execution of financial leasing contracts. Many of these institutions are part of a financial group in which a bank is also a member. As a result of the financial crisis of 1994, and considering that a bank may also

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17. See "Ley de Instituciones de credito," D.O., 22 July 1994, art. 122 [hereinafter "Law of Credit Institutions"].

18. See "Ley del mercado de valores," D.O., 23 Dec. 1993, art. 2 [hereinafter "Law of the National Banking and Securities Commission"].

19. See Law of Credit Institutions, *supra* note 17, art. 30.

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carry out financial leasing and factoring operations, mergers between these three types of intermediaries have been taking place in the last two years. These mergers have taken place between firms with capitalization problems.<sup>20</sup>

Financial factoring companies have the same legal structure as leasing companies, but their main objective is the execution of factoring contracts over creditors' rights.

General deposit warehouses' main purpose is the deposit and administration of goods under their guard, which are represented by certificates of deposit, as well as the granting of credits secured by those goods.

Savings and loans associations are types of savings and loans clubs (in a sense, a building society), in which the raising of funds can only be made through the contributions of their shareholders. The granting of credit can only take place for the benefit of those same shareholders.

Credit Unions authorization for operation is granted by the National Banking and Securities Commission. Credit unions are incorporated for operation in the same economic area of activity as their shareholders (e.g., mining exploitation). Their main purpose is the granting of credits for the development of that area for the benefit of the shareholders.

Money exchange houses are considered an auxiliary credit activity. Their main objective is the purchase, sale, and exchange of any type of currencies, an operation which can also be conducted by the banks.

#### d. Securities and Related Firms

In Mexico, the securities industry is primarily regulated by the Law of the Securities Market and is integrated by the stock exchange houses, securities firms, institutions for the deposit of securities (deposit and clearing houses), securities rating agencies, and limited scope securities firms or stock specialists. A review of the most important intermediaries of this industry follows.

Stock exchange houses' purpose is to facilitate securities transactions, as well as to promote the development of the securities industry. Only one stock exchange house exists in Mexico today.

Securities firms' importance grew significantly as a consequence of the banks' expropriation in 1982. However, with the creation of financial groups and the banks' reprivatization in 1991 and 1992, securities firms' participation in the market has been declining. The main purpose of these entities is to act as intermediaries in the securities market and to conduct other related activities.

Investment funds are intermediaries regulated by the Law of Investment Funds. Their main objective is the acquisition of securities and other related investment documents through a specific selection criteria, depending on the type of fund, with resources raised from the placing of their shares among investors.

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20. This may also be an argument in favor of implementing (or perhaps only consolidating) a German style universal banking system in Mexico.

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e. Insurance and Bonding Institutions.

Insurance companies are financial intermediaries whose main purpose is to economically offset a potential risk as consideration for payment of premiums.

Bonding institutions' main objective is to economically guarantee the fulfilment of an obligation or a responsibility by a person through the payment of premiums by the latter.

f. Holding Companies of Financial Groups.

In 1990, as a consequence of the financial transformation of Mexico, a new Law for the Regulation of Financial Groups was issued in order to establish the possibility for the incorporation of financial groups integrated by different financial entities in which the holding company would hold the majority of the shares of each of the entities. The holding company is banned from conducting any type of operation; its sole purpose is to be the major shareholder of the entities.

The idea was to take advantage of economies of scale through the synergy of different companies within the same organization, thus reducing the costs involved in their operation. In addition, the holding company represents a safety guarantee for third parties for the transactions made by its affiliates.

A banking institution and a securities firm may coexist, as well as many other financial intermediaries (e.g., insurance and leasing companies), within the same financial group. This coexistence is considered by some scholars to be a type of universal banking system.<sup>21</sup> However, in a real universal banking system the banking and securities activities must be performed within the same entity or company, although other models (such as the English model, may also be considered universal, since the banks are allowed to invest directly in the equity of different financial intermediaries.

2. *The NAFTA's Impact on the Mexican Financial System.*

At the beginning of 1994, the North American Free Trade Agreement,<sup>22</sup> negotiated by the governments of Mexico, Canada, and the United States, came into effect, providing a deep transformation of the MFS, as it represented the opening of Mexico's financial services to full foreign participation.<sup>23</sup> As a result, in December of 1993, different amendments to the financial laws were passed in order to establish a chapter regulating the affiliates of foreign financial entities established in countries with which Mexico had executed an international treaty on free trade.<sup>24</sup> Importantly, the legal structure chosen by the Mexican Government for the participation of foreign financial entities was under the form of a subsidiary or affiliate, banning

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21. In this regard, see Richard Dale, *Regulating Investment Business in the Single Market*, BANK OF ENGLAND QUARTERLY BULLETIN, Nov. 1994.

22. North American Free Trade Agreement, drafted Aug. 12, 1992, revised Sept. 6, 1992, U.S.-Can.-Mex., 32 I.L.M. 605 (entered into force Jan. 1, 1994) [hereinafter "NAFTA"].

23. Foreign participation in the financial intermediaries had been limited to keep the control of the industry and thus the payments system in Mexican hands. Citibank was the only foreign financial entity with a branch operating in Mexico at the beginning of 1994. Other foreign financial institutions could have representative offices with very limited functions.

24. See Law of Credit Institutions, *supra* note 17, art. 45-N.

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the establishment of branches. The purpose was to facilitate the control of the monetary policy by the Bank of Mexico, as well as the financial supervision of the affiliates (although the home country may conduct an inspection visit, subject to certain limitations.)<sup>25</sup>

At the end of 1994, the first package of authorizations for the incorporation of banking institutions was granted, and this process continued through the first semester of 1996. As a result, eighteen new authorizations were granted for the operation of banks in the banking sector alone.

During the first two years of banking affiliate operation the banking affiliate's participation in the Mexican market has been rather conservative,<sup>26</sup> not yet affecting the domestic banking institutions. Moreover, the banking affiliates will likely focus their operations in corporate finance and risk management, leaving the retail banking for the Mexican institutions. In any case, the NAFTA's real impact on the MFS will have to be assessed once the transition period finishes (after the year 2000.)

### 3. *The 1994 Financial Crisis.*

On December 1, 1994 President Ernesto Zedillo took office in an apparently stable Mexico. However, after three weeks in office, due to the country's huge current-account deficit and the problems originated by guerrillas in the State of Chiapas, the President was forced to devalue the Mexican peso, undermining confidence in the government and financial sectors. A subsequent rise in inflation and the collapse of the stock and bond markets were perhaps the most severely destabilizing occurrences of all.<sup>27</sup>

The rise in inflation brought an increase in interest rates and, as a result, thousands of borrowers began having problems with their bank loans. In the banking sector, the fall of the Mexican peso and of the value of the government-bond holdings reduced the capitalization levels of several banks below the 8 percent minimum set by the Basle Committee, causing a severe liquidity crisis. Furthermore, many of the banking institutions had bad debts; a large proportion of loan loss reserves were affected as a result of inadequate credit analysis and ratings.<sup>28</sup> For both the financial sector and the regulatory and supervisory authorities, the MFS was in the worst possible condition. In order to support the MFS as a whole and, specifically the banking sector, the financial authorities in 1995 implemented different programs and amendments to the law which continued through to the first semester of 1996.<sup>29</sup>

Among these programs was an amendment to the Law of Credit Institutions<sup>30</sup> allowing for the acquisition of certain troubled domestic entities by foreigners, for their transformation into affiliates of foreign financial entities, and for the purchase of some of the banks' bad debt by FOBAPROA.<sup>31</sup>

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25. *Id.*

26. The main reasons for this behaviour are Mexico's financial and economic crisis of 1994 and the capital limitations (growth in its capital) applicable to the affiliates during the transition period agreed to in the NAFTA.

27. See *The Egg on Zedillo's Face and Latin America in the Fallout Zone*, THE ECONOMIST, Jan. 1995, at 43-44 and 67-68.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

Likewise, different programs for the support of borrowers were executed in an attempt to stop the deterioration of the banks' credit portfolio. The financial crisis and the banks' rescue plan had cost the Mexican taxpayers around 10 percent of the GDP.<sup>32</sup>

On the other hand, the regulatory and supervisory authorities also encouraged the merger of different entities within the same organization in order to reduce operating costs of the financial group as a whole. Generally, the idea was to merge the leasing, factoring, and money exchange companies with the group's bank, since those activities already permitted to be performed by banks.

As can be seen, a financial crisis may bring as a consequence a further shift of a financial system toward a universal banking model. The next step is to consider the inclusion of other activities within a single entity that could lead to a more efficient financial system.

## II. The English and German Financial Systems.

In any study that suggests the implementation of a new legal order to accommodate a new financial system, a comparative analysis with other countries' financial structures and legal systems is paramount, especially when those countries are at the vanguard of financial innovation.

This paper analyzes the English and German financial systems, including the laws that regulate them, as a starting point in the consideration of an implementation of a universal banking (UB) system in Mexico. Moreover, other legal systems in which UB systems have been implemented in the last few years, including the European Community, will be considered.

### A. THE ENGLISH FINANCIAL SYSTEM.

Traditionally, the English financial system is considered among the most important in the world.<sup>33</sup> Nonetheless, as in many other countries, different structural changes and regulations were introduced in the United Kingdom during the last two decades to cope with global financial innovation and the seemingly continuous fluctuations in both the public and the private sectors.

A review of the latest changes to the United Kingdom's legal financial framework and organizational structure follows. This section gives special emphasis to the so-called "Big Bang" and the enactment of the Financial Services Act of 1986,<sup>34</sup> whereby commercial banking institutions were allowed to enter the securities market through the establishment of ad hoc subsidiaries.

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32. *Id.*

33. *Id.*

34. The Financial Services Act of 1986 was enacted as a result of a study conducted by Professor L.C.B. Gower, the purpose of which was to determine the deficiencies of the investment business prior to this statute. Gower's analysis was primarily concerned with investor protection, not with systemic risks. See L.C.B. Gower, *Review of Investor Protection: Report, Part I*, C.M.N.D. 9125 (H.M.S.O. 1984).

### 1. *The U. K. Banking System.*

One of the main features of the United Kingdom's financial system is the mixture of foreign and domestic institutions in which foreigners are welcomed in the large international banking operations sector, while service of the domestic markets is traditionally reserved to the national institutions.

On the supervisory side, moral suasion and relative self-regulation approaches have been used by the Bank of England, the leading authority in charge of supervision and regulation of banking institutions in the United Kingdom. Through this technique, the Bank of England exercises its functions with the supervised entities on a friendly basis, issuing recommendations for the performance of the banks' operations.

In the United Kingdom there are more than 600 deposit-taking institutions, and these institutions can be divided into five main categories: clearing banks, merchant banks, other British banks, foreign banks, and other deposit-taking institutions.<sup>35</sup> Additionally, there are discount houses whose main function is to serve as a link for certain operations between the Bank of England and the banking institutions. The building societies can be categorized as other deposit-taking institutions, with a leading role in retail banking. A brief analysis of each of these entities follows.

Clearing banks are institutions with a large branch network and specialized deposit-taking and credit operations, though other services are provided either directly or through subsidiaries. Barclays Bank and National Westminster Bank are important examples of these banks.

Merchant banks are smaller banking institutions specializing in international trade finance and short finance. Merchant banks are considered investment banks, since their operations may involve investment management, underwriting, and trading of securities.<sup>36</sup>

Other British banks are mainly integrated by finance houses, with no participation in deposit-taking operations, but participation in consumer finance and personal lending transactions.

As previously noted, London is one of the major financial centers of the world. Not surprisingly, almost all of the world's major banks have a representation in the city through a branch, subsidiary, or representative office for the performance of international financial operations. These are known as foreign banks.

Other deposit-taking institutions are building societies that focus on the saving and loan transactions of their members. Their importance has been growing during the past several years as an alternative source of funding and service. Likewise, these intermediaries have been participating in other nontraditional financial services as a result of the deregulation process occurring in the United Kingdom. It is worth noting that the United Kingdom's financial intermediaries have been mixing their activities in recent years through the establishment of subsidiaries.

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35. ANTHONY SAUNDERS & INGO WALTER, *UNIVERSAL BANKING IN THE UNITED STATES: WHAT COULD WE GAIN? WHAT COULD WE LOSE?* 113 (1994).

36. William Blair, *Liberalisation and the Universal Banking Model: Regulation and Deregulation in the United Kingdom*, in *INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990s* 81, 84 (J.J. Norton et al. eds. 1994).

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## 2. *The Banking Act of 1979.*

The United Kingdom's traditional style of regulation, unlike the respective styles of many other European Community countries and the United States, is characterized by its flexibility and pragmatism, in which formal legislation plays only a minor role. Moreover, the absence of detailed statutes governing banking business allows the financial sector to conveniently adapt to the ongoing changes in a competitive and efficient manner, without losing the adequate control this activity requires in order to ensure its safety and soundness.

The Bank of England is directly responsible for this success. The central bank's main objectives are the United Kingdom's price stability and control of the money supply. Likewise, the Bank of England is in charge of supervising the banking sector and may act as a lender of last resort for institutions under its surveillance.

Until 1979 there were practically no laws specifically regulating the banking industry in the United Kingdom. The functions of financial supervision and of regulation were performed by the Bank of England using moral suasion and other informal approaches.<sup>37</sup> Different factors, including the U.K.'s banking crisis of 1973-74 (generally known as the "secondary banking crisis"),<sup>38</sup> and the entrance of the country into the European Community in 1973, forced authorities to re-evaluate the U.K.'s regulatory framework in the banking industry, enacting, as a consequence, the Banking Act of 1979.<sup>39</sup>

The secondary banking crisis of 1973-74 involved the implementation of a rescue package for the stability of the banking institutions under the supervision of the Bank of England. This rescue package was a consequence of a possible contagion from banks' failures outside the Bank's of England's supervision, which were conducting real estate financing when 1972's real estate crisis occurred. On the other hand, membership in the European Community brought the adoption and implementation of the first EEC Banking Directive of 1977,<sup>40</sup> requiring a specific authorization of the home country's authority for credit institutions operating within the community.

Before this act was passed, any partnership, company, or individual could take money on deposit. No licence was needed and no disclosure regarding the assets of the business or the way in which the bank was conducted was required.<sup>41</sup>

The Banking Act of 1979 established for the first time a comprehensive regulatory framework for banking institutions based on a licensing requirement. It categorized banking institutions for deposit-taking business into recognized banks and licensed deposit-takers.<sup>42</sup> In addition, a deposit protection scheme was incorporated to establish a degree of safety for depositors.<sup>43</sup>

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37. *Id.*

38. *Id.*

39. *Id.*

40. See Council Directive 77/780, art. 3, 1977 O.J. (L 332) 33.

41. Colin Mayer, *The Regulation of Financial Services: Lessons from the United Kingdom*, in *EUROPEAN BANKING IN THE 1990s* 44 (Jean Dermine ed., 1993).

42. Banking Act, 1979, Ch. 37, Part III, §§ 1 & 2 (Eng.).

43. *Id.* at Part II.

### 3. *The Banking Act of 1987.*

The introduction of the Banking Act of 1987 was again a direct response to different events and financial crises that arose at the beginning of the 1980s, such as the International Debt Crisis and the growth of the so-called off-balance sheet operations.

However, none of these events had the paramount repercussions of the Johnson Matthey Bankers Crisis of 1984. This institution accumulated large losses as a result of its lending activities and inadequate attention given to the guidelines set up by the Bank of England on lending limits and risk concentration.

Johnson Matthey was a fully authorized bank under the Banking Act of 1979, thus its failure highlighted the limitations and deficiencies of this statute. The Bank of England nationalized Johnson Matthey by securing 150 million sterling pounds for guarantees of other London banks.<sup>44</sup>

After the Johnson Matthey crisis, a period of reappraisals on the Bank of England's role followed, specifically focusing on its faculties in order to conveniently supervise the financial stability of the institutions under its scope. The Banking Act of 1987 is the result of this period of consolidation, in which the Bank of England continued as the leading regulator and supervisor of the banking institutions.

Among the important provisions of the Banking Act of 1987<sup>45</sup> is a clear responsibility (and thus, major accountability) for the Bank of England in the supervision and regulation of the financial institutions under its scope, as well as the recognition of only one category of authorized institutions for deposit-taking activities.<sup>46</sup>

### 4. *The "Big Bang" and the Financial Services Act of 1986.*

On the investment business side, the introduction of two main sets of amendments to the existing regulations implied a new regulatory and operational regime: the so-called Big Bang and the Financial Services Act, both of 1986.

The Big Bang was the result of the deregulation process of the London Stock Exchange.<sup>47</sup> In March of 1986, an amendment to the London Stock Exchange rules was introduced in order to allow 100 percent ownership of the stock-brokering and jobbing firms by nonmembers of the London Exchange. This amendment was followed in October of the same year by the abolishment of fixed commissions for securities trading and the elimination of the single capacity whereby the functions of market making and brokerage were to be performed separately by the financial intermediaries.

Of significant relevance was the modification of the members' ownership rule, since it established a clear path for the emergence of financial conglomerates led by commercial banking institutions. As Professor Richard Dale points out:

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44. Joseph J. Norton, *The Bank of England's Lament: The Struggle to Maintain the Traditional Supervisory Practices of "Moral Suasion"*, in BANK REGULATION AND SUPERVISION IN THE 1990S 25 (Joseph J. Norton et al. eds., 1991).

45. Banking Act, 1987, Ch. 22, § 1 (Eng.).

46. *Id.* at § 8.

47. See, e.g., David T. Llewellyn, *Universal Banking and the Public Interest: A British Perspective*, in UNIVERSAL BANKING, FINANCIAL SYSTEM DESIGN RECONSIDERED 181-183 (Anthony Saunders & Ingo Walter eds., 1996).

The change in ownership rules in particular had a dramatic impact on the structure of UK financial markets. Out of just over 200 original Stock Exchange member firms, more than a half had become part of larger financial groupings by the end of 1986.

In a one-step change banking and securities business was combined within newly established financial conglomerates and the separation of these activities which has characterized the UK financial services industry for three hundred years or more was abandoned.<sup>48</sup>

The new Financial Services Act (FSA) was also introduced in 1986, following the Gower Report.<sup>49</sup> The 1986 FSA established for the first time a comprehensive regulation of the investment business for the benefit of investors (and ultimately of markets), providing a clear demarcation from other financial services. The 1986 FSA also provided a definition of investments and stated that the enumerated activities should only be conducted by authorized or exempted persons. Moreover, the FSA established a regulatory and supervisory structure led by the Securities and Investments Board and Self-Regulating Organizations in charge of the different investment sectors and activities.<sup>50</sup>

The Big Bang and the 1986 FSA indirectly promoted the integration of financial conglomerates, whereby an economic group provides a wide range of financial services under the same corporate philosophy and name. The U.K.'s financial conglomerates are not groups in which a holding company acquires a significant participation in each of the intermediaries (e.g., the U.S. or Mexican systems), but are groups in which a leading institution (usually a clearing bank) participates in a wide range of services through their own subsidiaries, clearly constituting a UB model.

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48. RICHARD DALE, *INTERNATIONAL BANKING DEREGULATION: THE GREAT BANKING EXPERIMENT* 107 (1992).

49. See *supra* note 27.

50. The Self-Regulating Organizations (SROs) are the following: 1) Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA); 2) Investment Management Regulatory Organization (IMRO); 3) Life Assurance and Unit Trust Regulatory Organization (LAUTRO); 4) The Securities and Futures Authority (SFA); and 5) Personal Investment Authority (PIA). The SROs are integrated with members of the investment firms and carry out licensing and supervisory functions within the sphere of its objectives. Recent years have witnessed several proposals for the modification of this regulatory system, since it is considered complicated and inefficient. The alternative provided by Michael Taylor of bringing together the prudential supervision of banking, securities, and insurance within the ambit of a single regulatory agency (Financial Stability Commission) and the consumer protection under the scope of another agency (Consumer Protection Commission), seems to be attractive. More recently, the new Labor Government proposed an eventual single authority in charge of supervising and regulating the majority of the financial intermediaries. In any case, the ultimate goal (and perhaps the most important one) of prudential supervision is consumer protection, so both objectives should coexist within the same organization. For further analysis, see Michael Taylor, *Twin Peaks: A Regulatory Structure for the New Century and Peak Practice: How to Reform the UK's Regulatory System*, Centre for the Study of Financial Innovation (CSFI), Nos. 20 & 23, Dec. 1995 and Oct. 1996, respectively. See further *Reforming the City*, THE ECONOMIST, Feb. 1997, at 19; *The City of London, Stitched up*, THE ECONOMIST, Feb. 1997, at 102; *Labour turns to the City*, THE ECONOMIST, May 1997, at 15; and *Shaking up City Regulation*, THE ECONOMIST, May 1997, at 111.

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The U.K.'s financial system may be considered a hybrid of the German universal banking model and the U.S. system, in which the latter rigidly separates banking from investment services under the Glass-Steagall Act.<sup>51</sup> In the U.K. system there is an active participation of the banking industry in other services, although not directly, as in Germany.

#### B. THE GERMAN FINANCIAL SYSTEM.

Few financial systems in the world have been the subject of such strong debates as the German system. For many, the German system is considered one of the most liberal banking systems, in which the mixing of banking and securities activities within the same institution have proved to be very reliable. Moreover, the German banking institutions maintain substantial investments in the equity of nonfinancial companies as part of a deliberate strategy for the strengthening of the links between financial institutions and the industry, and not only for investment purposes.

##### 1. *The German Banking System.*

The German Banking System (GBS) is considered by scholars as the prototype of a UB model. Once again, this universal system implies the participation of banking institutions in a full range of activities, even securities, through the bank entity itself rather than through separately incorporated subsidiaries.<sup>52</sup>

Although a UB system predominates in Germany, there are also specialized institutions whose operations which not expressly circumscribed by the corresponding authorizations. Likewise, the term universal banking does not imply that these institutions may freely perform any kind of financial services, due to these particular restrictions.

As with the Bank of England, the German Central Bank (*Deutsche Bundesbank*) is in charge of the stability of the monetary system as a whole and, indirectly, of the stability of the German financial system. Unlike the Bank of England, the German Central Bank is not directly responsible for the supervision of banking institutions. This function is conducted through a separate supervisory authority under the auspices of the Ministry of Finance. Indeed, the Federal Banking Supervisory Office (*Bundesaufsichtsamt für das*

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51. JOHN H. FRIEDLAND, *THE LAW AND STRUCTURE OF THE INTERNATIONAL FINANCIAL SYSTEM: REGULATION IN THE UNITED STATES, EEC, AND JAPAN* 8 (1994).

52. Most scholars agree with this definition of universal banking. See, e.g., Theodor Baums, *Universal Banks and Investment Companies in Germany*, in Saunders & Walter, *supra* note 47, at 124; and JUKKA VESALA, *RETAIL BANKING IN EUROPEAN FINANCIAL INTEGRATION* 100, 101 (1993). However, the conception of universal banking may vary among the scholars considering German UB, to the offering of all types of financial services through different subsidiaries. See Saunders & Walter, *supra* note 47, at 184-185. Moreover, some scholars may also associate the concept of universal banking with the establishment of linkages between banking and industry, through the acquisition of equity holdings in their client companies. See Blair, *supra* note 36, at 138; Saunders & Walters, *supra* note 47, at 87; Friedland, *supra* note 51, at 1. A true universal banking system must be characterized by the offering of banking and securities businesses through the same entity, in which the establishment of linkages with the industry is considered accessory. However, the U.K. model may also be considered a universal banking system, since the banks own their investment subsidiaries.

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*Kreditwesen*) supervises the commercial banking activities in strong cooperation with the Central Bank. While the former is in charge of licensing institutions, performing on-site examinations, and, in general, the regulating of the banking sector, the latter processes information gathered from the institutions for statistical purposes and supervises capitalization levels and the liquidity of the system as a whole.

a. Universal Banks.

The universal banks are considered the core of the German banking sector,<sup>54</sup> and can be divided into three main classifications.

The first classification is private commercial banks, which is in turn divided into four categories: the large international German banks and their subsidiaries and branches (*Grossbanken*),<sup>55</sup> the regional banks (*Regionalbanker*), other private banks established as partnership or as sole proprietorship (*Privatbanker*), and the branches and subsidiaries of foreign financial institutions.

These institutions, and, in particular, the three large international German banks, maintain a dominant position in the securities business; generally speaking, the domestic operations in this sector are conducted directly by the banks.<sup>56</sup> Moreover, as a consequence of this predominance there are no German securities firms operating in the market.

Commercial banks incorporated under public law are banking institutions that are incorporated in accordance with a state law and are generally owned by their respective municipalities and districts. They are designed to promote savings and credit finance in certain regional areas.

Commercial credit associations and rural credit associations are organized under the legal form of a cooperative for the primary benefit of their members. They are established principally for the development of agricultural and commercial businesses and thus also operate within a certain region.

These universal banks are allowed to perform all types of banking activities in accordance with the definition provided by the current German Banking Act of 1961. However, many of the entities have a *de facto* specialization, since their priorities and strategies may vary.

Furthermore, there are certain financial services (notably insurance) that cannot be carried out by the banking institutions themselves, and require a separately capitalized insurance subsidiary. In practice, and for strategic and capitalization reasons, the major banking institutions have separate subsidiaries for their operations abroad.

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53. The purpose of an on-site examination is to evaluate the overall financial condition of an institution through the appointment of a team of inspectors in the offices of the intermediary.

54. See, e.g., Marcello Clarich, *The German Banking System: Legal Foundations and Recent Trends*, European University Institute (EUI) Working Paper No. 87/269, at 15.

55. Deutsche Bank, Dresdner Bank, and Commerzbank.

56. Dale, *supra* note 48, at 139, 145.

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b. Specialized Banks.

Specialized banks are institutions with a particular legal regime whose purpose is to provide financial services to a certain economic sector or region. The main specialized banks are mortgage banks incorporated under private or public law. Building loan and savings banks, installment finance banks for the granting of credits to consumer businesses, and the postal giro and postal savings banks are also important.

2. *The Banking Act of 1961.*

The main banking legislation of Germany is the amended Banking Act of 1961 (*Gesetz über das Kreditwesen*).<sup>57</sup> This act, which replaced the Banking Act of 1934, provided the German banking system for the first time with a comprehensive and uniform legal framework for the operations to be carried out by the banking institutions. Moreover, it established that universal banks may engage in a full range of financial operations and services with only certain limitations.

The Banking Act of 1961 does not, however, provide a clear classification of the types of banking institutions, but only lists the activities that may be carried out by these entities. Indeed, the universal banks in Germany are allowed to perform a wide range of financial services, from the taking of deposits and the granting of credits to securities underwriting and trading, subject to the granting of the corresponding license by the proper authority.<sup>58</sup> In addition to the listed activities, the German banks may also engage in other services and operations that are customary to them, such as financial leasing and factoring, dealing in precious metals and foreign exchange, and acting as real estate brokers.<sup>59</sup>

There are, however, some limitations to the concept of UB, specifically in connection with insurance business, in which a separate license to an ad hoc company is required. Likewise, there are certain investment activities, defined in accordance with the Investment Companies Act, that may not be carried out by the banking institutions directly. By contrast, the investment companies are subject to the granting of a banking licence under the Banking Act in order to perform these activities.<sup>60</sup>

Another important feature of the Banking Act of 1961 is that the banks are generally allowed, subject to certain limitations, to invest in the equity of financial and nonfinancial

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57. The German Banking Act of 1961 was amended on three main occasions: in 1976, in order to establish certain prudential measures in the operation of the banks and as a result of the Bankhaus I.D. Herstatt's crisis of 1974; in 1985 to provide for the consolidation of banking groups for capitalization and credit exposure purposes; and in 1993, to incorporate the EEC Second Banking Directive into German legislation.

58. See *Gesetz über das Kreditwesen* [German Banking Act] § 1(1), v. (BGBl I 881).

59. See Theodor Baums & Michael Gruson, *The German Banking System - System of the Future?*, 19 BROOK. J. INT'L L. 101, 107 (1993).

60. See also, *Gesetz über Kapitalanlagegesellschaften* [Investment Companies Act] § 1, 2(1), 10(1)(2), v. (BGBl I 127). The investment funds shall only be established and administered by investment companies to ensure certain independence from the bank, thus acting in the exclusive interests of the investors. Nevertheless, banks may also own investment companies in Germany.

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companies.<sup>61</sup> The German banks' investments in other nonfinancial companies are part of a deliberate strategy to strengthen links between the two sectors, and not only for investment portfolio purposes.<sup>62</sup> This investment policy does not affect the capacity of the banks to act as trustees or agents of third parties, in which investments in securities may also be made.

### 3. *The German Experience on Universal Banking.*

The German banking system not only has typical UB institutions, but also many other specialized intermediaries that provide specific financial services within a certain geographical region. It also incorporates other institutions such as insurance and investment companies, since legal requirements do not allow banks to engage directly in these services. Moreover, UB does not preclude certain specialization for business purposes. As Bernd Rudolph points out:

This common characteristic [of universal banking] does not exclude some specialization with respect to certain customers or business activities on the basis of historical, regional or strategic differences. Therefore we cannot speak of a uniform type of universal banks.<sup>63</sup>

Nevertheless, Germany is by far the world's principal proponent of UB, so a consideration of its experience with the UB is fundamental to assess the implementation of this system in other jurisdictions. Of course, it is important to bear in mind that Germany's financial, economic, historical, and even cultural conditions would not necessarily be shared by other countries, thus a case-by-case analysis must be conducted.

To the extent that universal banking implies the direct participation of a single banking institution in a wide range of financial services (mainly commercial banking and securities business), there is no evidence of any financial problem arising as a consequence of

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61. In accordance with section 12 of the German Banking Act of 1961, the investments made by a bank in other financial institutions, commercial and industrial companies, and other certain assets may not exceed in the aggregate, and measured by book value, the liable capital of the bank. However, investments in shares of a company that do not exceed 10% of the capital of that company are not considered for purposes of the aggregate limit. Nonetheless, the 1993 amendments to the Banking Act, in order to incorporate the EEC Second Banking Directive into German legislation, established a maximum individual investment of 15% of the bank's capital on a non-financial company and 60% in the aggregate, unless the bank covers the investments in excess of these percentages with liable capital and does not include that portion of liable capital in its capital ratios.

62. In Mexico, Article 75 of the Law of Credit Institutions allows commercial banks to invest in the capital of non-financial companies (other than those that may render the banks a specific back-up service such as real estate companies or other complementary services companies) subject to more conservative limits than those established for German banks. However, the only purpose of this provision is to enable the banking institution to diversify its investment portfolio, since the establishment of close linkages between banking and industry has been discouraged, at least when considering the investments made by a bank.

63. Bernd Rudolph, *Capital Requirements of German Banks and the European Community: Proposals on Banking Supervision*, in *EUROPEAN BANKING IN THE 1990s* 375 (Jean Dermine ed., 1993).

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this concentration of functions. Other implications, however, such as conflicts of interest, must be further evaluated.

In connection with the universal banks' holdings in the capital of nonfinancial companies, a different approach must be followed. Although none of Germany's financial crises have been the direct result of the UB model of that country (e.g., Bankhaus I.D. Herstatt's crisis), these holdings are the most delicate part of the German system, since they rely on the performance of third party nonfinancial companies with limited supervision and regulation by the authorities.<sup>64</sup>

Moreover, the establishment of close linkages between banking and industry may lead the former to grant preferential credits to the latter with bad spreads in the operation, along with an underestimation of the importance of good credit analysis. Another feature of the German banking experience is perhaps the excessive power of the banking sector in relation to the rest of industry, although further research in economics rather than law should be undertaken in order to assess the real implications of this phenomenon.

It seems German universal banks have been rather conservative in the exercise of operations in comparison with the faculties granted to them by law. Furthermore, although Germany is a relatively liberal jurisdiction in the financial services sector, its intermediaries have shown a high degree of maturity by adopting a prudential attitude toward loan-loss reserves and risk management.

### C. THE EUROPEAN COMMUNITY AND OTHER JURISDICTIONS.

#### 1. *The European Community.*

Through the adoption and implementation of the Second Banking Directive,<sup>65</sup> the Member States of the European Community (EC) accepted the single banking license principle, as well as the mutual recognition of licenses and banking supervisory systems within the community. Through this single license, banking institutions of any Member State are allowed to conduct activities in the territory of another Member State by establishing branches or by providing cross-border services. These activities are available without additional authorization from the host country, provided the home country's proper authority granted the corresponding license.

For purposes of determining the type of operations the banking institutions would be allowed to carry out in any Member State's territory, the directive established a list of permitted activities that would be subject to mutual recognition by the Member States.<sup>66</sup> The approach followed by the EC incorporated a full range of banking services (including securities operations) under the single license principle, although other services, such as insurance, were not listed. This model enables a banking institution to directly provide banking and securities services within the same entity or company, which would clearly

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64. For further analysis on the performance of German universal banks, see, e.g., Dale, *supra* note 48, at 144-147.

65. Council Directive 89/646 1989 O.J. (L 386) 1, as amended by Council Directive 95/26 1995 O.J. (L 168) 7 [hereinafter "Second Banking Directive"].

66. *Id.*

constitute a UB model.<sup>67</sup> The adoption of this policy was in tune with the deregulation process experienced by different European countries, as well as with the tendency toward integrated financial services of the institutions or the mixing of activities.

The idea was also to harmonize the European Community's different banking systems by establishing a broad definition of the activity that may encompass the liberal regulatory frameworks of Germany and other countries with similar models, while at the same time allowing their banking institutions to conduct activities in more conservative jurisdictions such as the United Kingdom. Although the Second Banking Directive lists a wide range of investment operations under the scope of the banking license, the participation in the capital of nonfinancial companies is limited to 15 percent per single entity, with an aggregate limit of 60 percent of the bank's capital.<sup>68</sup> Finally, although the Second Banking Directive allows a bank to provide directly banking and securities operations, the European Community also issued the Investment Services Directive<sup>69</sup> to ensure the mutual recognition of securities firms and supervisory systems among the Community's Members. Another aim of this Directive was to promote greater competition and access to the securities markets and stock exchanges in the European Community. Therefore, the securities and investment industries are regulated with a specific directive and are thus not included in the Second Banking Directive.

## 2. Other Jurisdictions.

In addition to Germany and the United Kingdom, other European countries have banking systems in which a "universal model" has been considered in some way. Notably, Switzerland, France, Italy, and Holland have models similar to Germany's, and their experiences have been satisfactory so far, at least to the extent that no banking failures in those countries have been the result of their respective banking systems.

Other countries, such as the United States, Canada, and Japan, have been adopting measures in recent years toward a growing liberalization of their financial systems in order to cope with the greater competition faced by their financial intermediaries. In the case of the United States, for example, several different proposals have been submitted by the Treasury Department since 1991, all designed to promote the modernization of the financial system. The United States' Glass-Steagall Act of 1933<sup>70</sup> rigidly separates commercial and investment banking, thus prohibiting banks from underwriting or purchasing securities on their own account. The Act originally passed as a result of the U.S. banking crisis of 1929-1933, in which banking institutions were heavily involved in securities and investment operations. Nonetheless, certain effects of the act were diminished by judicial deci-

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67. However, there are some scholars who may disagree with this idea. In this regard, *see, e.g.*, Rosa María Lastra, CENTRAL BANKING AND BANKING REGULATION 226 (1996).

68. Second Council Directive, *supra* note 65, at art. 12.

69. Council Directive 93/22 1993 O.J. (L 141) 27, *as amended* by Council Directive 95/26 O.J. (L 168) 27.

70. U.S. Banking Act of 1933, 12 U.S.C. §§ 24, 335, 377, 378 (1994) (commonly known as the Glass-Steagall Act). Sections 16, 20, 21 and 32 of the act are related with underwriting and sale of securities.

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sions or regulations issued by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board.<sup>71</sup>

More recently, the OCC announced its intention to allow banks to establish subsidiaries dealing with securities, insurance, and leasing, avoiding as a consequence the holding company structure required until now. Although seriously considered, a complete reform of the United States financial laws toward a UB model has not been passed.<sup>72</sup>

Japan is another important example of the financial deregulation process. After World War II, a system similar to the United States' was implemented, restricting the banks' participation in securities operations. However, Japanese financial authorities are considering lifting these restrictions in order to increase competition and to strengthen the financial system as a whole.<sup>73</sup> There is a global tendency to review the legal framework affecting the different financial systems of the world with the result of broadening the scope of banking institutions activities. Generally, the most achievable option is the universal banking structure.

### III. Universal Banking as an Option for the Mexican Financial System.

This final section analyzes the potential implementation of a UB model in Mexico, taking into consideration the particular characteristics of the Mexican Financial System (MFS). This section considers two options of UB:<sup>74</sup> the model in which a bank directly participates in a wide range of activities (even securities operations), but not in insurance and bonding; and the system in which a bank participates in all types of financial services through the establishment of *ad hoc* subsidiaries, but not through a holding company. This section further discusses the implications of allowing Mexican banks to hold a significant ownership interest in the capital of non-financial companies.<sup>75</sup>

#### A. UNIVERSAL BANKING IN MEXICO.

UB is one of the main products of the financial deregulation process, but is not the only one. Since many countries are adopting measures toward a growing deregulation of their financial services industries eventually leading to UB, this model should be the most efficient one or, at least, a model in which the maximization of resources can easily take place.<sup>76</sup> In a country like Mexico in which strong financial reforms were adopted in the last few years, UB may represent the natural next stage on regulation for the strengthening of Mexico's financial system.

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71. During the 1980s, banks were allowed by the Federal Reserve Board to underwrite limited amounts of certain securities as well as to offer other financial services. Since 1989, banks are authorized to underwrite securities through bank holding company affiliates and under certain limits (also known as section 20 affiliates).

72. Ralph Atkins, *German Growth Gloom Deepens*, FIN. TIMES, Nov. 22, 1996, at 3; and *Banking Reform Momentum*, THE ECONOMIST, Feb. 1997, at 95.

73. See, e.g., *Changing Japan*, THE ECONOMIST, Jan. 1997, at 19, 21.

74. See *supra* note 51.

75. See *supra* note 61.

76. See, e.g., Alfred Steinherr & Christian Huveneers, *Institutional Competition and Innovation: Universal Banking in the Single European Market*, in EUROPEAN BANKING 131 (Andy Mullineux ed., 1992).

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Mexican banks may only perform those activities and services expressly allowed by the Law of Credit Institutions.<sup>77</sup> Banks are allowed to carry out financial leasing and factoring and may also act as administrators and investors in investment (mutual) funds. Furthermore, banks may trade with securities, although trading with instruments leading to a public offer is banned and reserved to the securities firms.

In practice, there are few operations that banks cannot perform in Mexico (notably insurance and trading with certain types of securities). Therefore, opening the list of permitted activities to other operations may result in a reduction of costs and an increment in efficiency.

### *1. The Financial Groups Issue.*

In a financial group, the holding company should be the proprietor of at least 51 percent of the equity of each intermediary and must participate in at least two different financial institutions (whether they are banking, securities, or insurance firms) or three different institutions if the group does not include two of these previously mentioned entities.

The purposes of financial groups are twofold: first, they allow a single economic unit to diversify its financial operations and thus offer different services to the public under the same corporate seal with a corresponding reduction in costs; and second, they provide the public with an additional security in their operations, since in theory, the holding company would become responsible for the fulfillment of the obligations undertaken by its subsidiaries.

Although the financial group could be regarded as a UB model, it substantially differs from the German or even the English approaches. Indeed, under the Mexican system the subsidiaries of the group remain independent legal entities and are regulated and supervised accordingly. Moreover, the structure of these groups is often considered complex, since in the same organization a large number of intermediaries and other back-up companies may coexist, making their supervision and regulation rather complicated.

With respect to the second main purpose of the financial groups, the 1994 Mexican financial crisis showed that some holding companies were unable to support the deficient financial condition of their banks, either because of the relative size of the banks within the group, or because of the proper financial situation of the holding companies. This has serious consequences for the system as a whole. Nevertheless, the most important issue against the financial groups remains under the banks' umbrella. Once again, the heart of the MFS is represented by the banks. Banks are entitled to conduct a wide range of financial operations with only few exceptions.

Establishing two divisions within the same entity, one targeting commercial banking and the other investment banking, could be the first step toward the consolidation of the MFS. Furthermore, securities firms have been diminishing their participation in the market both as a consequence of the reallocation of a significant percentage of securities operations (i.e., money markets) in the banks' trading divisions, and the smaller capital of these entities, which limits their ability to perform certain operations.

As of today, banking in Mexico implies only deposit-taking and the granting of credits, although other related activities are included in the definition. The offering of all types of securities operations may naturally fall within the scope of banking, since these institu-

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77. *Id.*

tions already perform certain activities of this kind. Insurance, however, should be left outside banks' activities, since these operations are of a completely different legal nature, and insurance accounting principles bear no relation to those of banking.

## 2. *Proposal of a New Model for Mexico.*

Taking into consideration this article's review of and conclusions on UB, a new regulatory model based on UB can be suggested for the MFS. This proposal deserves more detailed analysis in accordance with the circumstances of the moment not only from the legal point of view, but also from the perspective of economics and accounting. There are two main options to be weighed: the German Universal Banking Model and the U.K. Universal Banking Model. Mexican banking institutions are allowed to perform directly any type of banking and securities activities,<sup>78</sup> plus other services related to these activities (i.e., financial leasing and factoring, money exchange, and acting as a trustees or fiduciaries). Direct participation in other financial services such as insurance and bonding is banned, although allowed through the establishment of subsidiaries.

The U.K. Universal Banking Model implies the eventual disappearance of the Mexican financial group since the banking institutions would be allowed to invest in the equity of any financial intermediary (but not otherwise), including securities firms, and insurance and bonding companies.<sup>79</sup> Banks would be the prevailing and leading entities of these new banking groups.

In any case, the range of banking activities should be increased in order to include the operations reserved for securities firms. In the second model, banks have the option of performing these services either directly or through securities firms. Likewise, banking institutions would be allowed to open an investment division subject to certain regulatory limitations.

The first model would anticipate an eventual disappearance of securities firms, since bank management would be tempted to perform all securities operations through a specific division of the bank. This would have as a consequence a significant reduction in costs and reallocation of funds, thus increasing the bank's efficiency. Nevertheless, the proposal in the first model leads to a widening of banks' permitted activities, and not necessarily the disappearance of securities firms, which would only happen as a possible consequence. These two intermediaries may coexist under this new scheme, especially when considering a firm undertaking securities operations exclusively (i.e., not mixing both activities).

In the first option, the financial group model could be kept as an alternative for certain financial conglomerates (i.e., non banking or securities groups). However in this scenario, since banks would invest directly in insurance and bonding companies, as well as in other financial intermediaries, the financial group's utility will be reduced. Of course, in no case should banks be allowed to offer insurance and bonding services directly.

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78. As defined by articles 46 and 22 of the Laws of Credit Institutions and Securities Commission, respectively, *supra* note 18.

79. In accordance with article 89 of the Law of Credit Institutions, *supra* note 17, banks are already allowed to invest in the capital of any financial intermediary other than securities firms and insurance and bonding companies.

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On the other hand, certain financial entities, such as leasing, factoring, and money exchange companies would continue to merge with banks, since their operations are allowed to the latter. Other financial companies, such as savings and loans associations, credit unions, general deposit warehouses, and limited scope financial companies would maintain their role in the MFS, since these institutions are performing specific operations for specific market niches.

### 3. *Advantages and Disadvantages of Universal Banking in Mexico.*

#### a. *Advantages.*

The first advantage Mexico would experience is a consolidation of the MFS. As a result of the inevitable mergers and acquisitions there would be an eventual reduction in the number of intermediaries providing financial services. The regulatory operating rules for the entities would become simpler and fewer in number, taking into consideration the reduction in the actual number of firms, as well as the concentration of functions in banks. The increased supervisory simplification would reduce the regulatory expenses of both authorities and the supervised entities. The financial entities will be able to offer a wider range of financial services through a single entity or banking group. The banks ideally will pass on to their customers any reduction in costs resulting from the banks' greater economies of scale and reduced regulatory expenses. The bank's network of branches will offer all the services allowed to the institution and the information gathered from the bank's clients will be better used by all the divisions of the bank.

Greater financial stability will follow from the banks increased ability to cope in a more responsive manner with ongoing financial market fluctuations. Their diversification will allow them to adjust the manner in which they provide services to their customers.<sup>80</sup> In addition, universal banks are likely to become large institutions with solid capital bases, better able to deal with economic or financial crises. The adoption of the universal banking system will indirectly force the owners and management of each institution to conduct a reappraisal of their institutional strengths and weaknesses. Such self-examination ideally leads to greater overall strength and financial soundness.

#### b. *Disadvantages.*

On the other side of the coin, some may argue that UB would lead to a lack of specialization and hence, of a reduction in the level of expertise in a certain field, since banks will diversify their operations. However, this is improbable considering that the human resources attending the different divisions of the bank are likely to be the same in the new entity.

UB is not for all banks. The potential growth and conversion of an institution must be analyzed in accordance with the particular characteristics of the entity. Therefore, allowing banks to universalize may force unnecessary conversions, acquisitions, and mergers, as banks perceive a conversion is necessary to remain competitive.<sup>81</sup>

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80. See, e.g., GEORGE J. BENSTON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED* 212 (1990).

81. See, e.g., Jack Revell, *Strategies of Major British Banks since the Big Bang*, in *THE CHANGING FACE OF EUROPEAN BANKS AND SECURITIES MARKET* 93 (Jack Revell ed., 1994).

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Conflicts of interest must also be dealt with more comprehensively in the UB system. Conflict of interest problems arise due to the multiple functions of the bank as investment and commercial banker, fiduciary, and originator of credit. While conflicts problems may create liabilities, the bank can take advantage of its greater breadth to better serve its clients and become more competitive in the marketplace.

The issues with systemic risk in a UB system are twofold. First, the risk of an overall financial crisis is greater: since two of the major financial providers are under the same roof, the possibility of a contagion between them is increased. In the case of universal banks, this is a real possibility since the financial condition of the intermediary could be dramatically affected by the lack of corporate separation between the banking and securities functions. Second, universal banks may be tempted to incur unnecessary risks in the securities field, considering the institution could be protected by a deposit insurance scheme or by the central bank as a lender of last resort.<sup>82</sup>

There is also the potential for an over-concentration of power in the hands of one institution. This consideration has two main implications. First, universal banks could become large financial institutions in which the concentration of banking and securities within the same entity will give them a comparative advantage over other specialized institutions. Second, investments in nonfinancial companies could represent incredibly large monopolies, concentrating national economic interests in a few hands.

The banks' investments in nonfinancial companies is one of the most important issues when considering UB. Nonfinancial companies are less regulated and supervised, thus the bankruptcy of one of the bank's affiliates may endanger the financial condition of the entire institution.

#### B. REGULATION AND SUPERVISION OF THE NEW SYSTEM IN MEXICO.

Adequate regulation and supervision of a financial system is vital to ensure its safety and soundness. In principle, the regulation and supervision of UB in Mexico should not represent an impossible task, especially considering that on the prudential side the MFS has been experiencing a profound transformation in the last few years.

##### 1. *Regulatory Issues.*

###### a. *Authorization.*

An application for the conversion into a universal bank will be analyzed by the competent Mexican authorities and the corresponding authorization will be granted only to those institutions fulfilling certain requisites of viability (e.g., justification, financial stability of the institution, managerial competence, adequate capitalization). UB will not be an option of absolute right. For new banking institutions, a similar procedure will take place, but the analysis will focus on the operating plan of the proposed bank and its initial capital adequacy.

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82. Dale, *supra* note 48.

b. Legal Amendments.

Different legal amendments to the Laws of Credit Institutions, the Law of Securities Markets, and other laws pertaining to insurance and bonding will have to be introduced to allow the participation of banks in all types of securities activities. These amendments are also necessary to allow these entities to invest in the capital of securities, insurance, or bonding firms, subject to the authorization referred to in the preceding paragraph. Secondary relevant regulations will have to be modified accordingly. Provisions allowing a greater percentage of investment in nonfinancial companies would have to be introduced, with limits similar to those established by the EEC Second Banking Directive.<sup>83</sup>

c. Chinese Walls.

A strict set of rules limiting the transfer of certain information between the different divisions of the bank or banking group would have to be implemented to prevent the development of any conflict of interest.

d. Prudential Regulation.

In becoming universal, the bank will increase its complexity and prudential provisions will need to address the attendant increase in risk. In particular, a stronger capital base will be required, together with comprehensive accounting and disclosure of information rules. Investments in non-financial companies will be limited, as well as the granting of credits to related parties (e.g., affiliates).

e. Antitrust Laws.

Banks' long-term investments in nonfinancial companies for long periods of time would be subject to approval by competent antitrust authorities and to limitations established in the corresponding laws.

2. Supervisory Issues.

The most important aspect in connection with the supervision of universal banks (i.e., an integral supervision) is already in place in Mexico. Indeed, in 1995 the National Banking and National Securities Commissions were merged to face the challenges of the new MFS. Under a single head, the new Commission supervises the vast majority of financial intermediaries in Mexico and conducts a comprehensive and integral analysis of the financial groups' condition.

In a UB model, the supervisory authorities would have to deal with the following main problems. An adequate monitoring system preventing the breach of any prudential limit imposed on the bank would have to be implemented to guarantee its healthy performance. Likewise, off-site analysis of the information provided by the banks will be essential, with the purpose of determining the development of any risk or incorrect accounting registration. Unnecessary risk taking, especially on the securities side, will have to be prevented to avoid any damage to the bank's financial condition. Accordingly, a depository

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83. See *supra* note 60.

protection scheme or safety net will be available to universal banks. Further, supervisors will have to prevent unfair competition among universal banks and specialized institutions that may endanger the efficiency and healthy development of the MFS as a whole.<sup>84</sup> With adequate supervision, healthy competition may result in the conversion of the MFS into one of the leading financial centres of Latin America. Special attention should be given to the rise of conflicts of interest for both the client's protection and for adequate competition among the institutions. Finally, universal banks' management capabilities will have to be assessed in accordance with the new complexity of the institution, thus requiring a higher degree of moral and technical qualifications from the bank's executives.

#### IV. Conclusion.

For purposes of this analysis, UB is defined as the ability of a single financial intermediary to perform all types of banking and securities business, as well as investment, leasing, factoring and other related activities, but not insurance and bonding, in which different legal and accounting regimes operate. Likewise, UB has the connotation of allowing a banking institution a majority investment in the capital of all types of financial intermediaries, even of insurance and bonding companies, rather than through a holding company.

The main argument of this analysis relies on the consideration given to the securities operations as an integral and natural part of the banks' activities. This consideration is even more important in countries in which the banks are already allowed to conduct certain types of securities business.

UB represents one of the most attractive options of the deregulation process. However, UB is a model in which implementation should be analyzed in accordance with the particular characteristics of the targeted jurisdiction. Despite the significant advantages UB offers over the specialization model, it would be unfair to say that this system is superior to those regimes in which a clear separation between banking and securities exists.

In Mexico, the UB model represents an achievable option, especially considering the strengthening transformation of Mexico's financial system over the last seven years. UB implies a further step in this strengthening process, with its promise of consolidation and increment of efficiency.

If UB is considered as an option for the MFS, its implementation shall not imply the disappearance of specialized intermediaries. Indeed, the coexistence of universal banks and specialized institutions (i.e., securities firms) could result in greater competition for the benefit of the public and of the system as a whole.

In addition to insurance and bonding firms, other financial intermediaries such as limited scope financial companies, general deposit warehouses, investment funds, credit unions, and saving and loan associations, will retain their role in the marketplace, targeting the particular niches for which they were originally created. In any UB system, however, the disappearance of leasing and factoring companies and money exchange houses is inevitable as the operations conducted by these entities will be absorbed by the banking institutions.

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84. See Myron L. Kwast, *Supervising the Universal Bank*, in *UNIVERSAL BANKING: FINANCIAL SYSTEM DESIGN RECONSIDERED* 744-745 (Anthony Saunders et al. eds., 1996).

If an English approach to UB is followed, the financial group's utility will be reduced, since banking institutions will be allowed to invest directly in the capital of any financial intermediary. However, the financial group could be kept as an option for certain conglomerates of which banks are not a part.

UB is not an option for everyone. Competent authorities will need to carefully analyze banks' applications for becoming universal and in each case, authorization would only be granted to those institutions that fulfilled the various requisites of viability. A strong financial condition along with competent management are fundamental for the granting of a universal banking license. Given these requirements, some financial intermediaries may choose to remain specialized.

UB could be risky, therefore, regulation and supervision by the competent authorities are essential to minimize adverse consequences of risk. In particular, the introduction or amendment of laws and regulations in connection with the structure of the MFS and of other prudential provisions should be conducted in a comprehensive and careful manner, taking into consideration other countries' experiences on the subject. Financial supervision will be easier and more efficient once the adequate regulations are in place. Nevertheless, the supervisory authorities will bear the ultimate responsibility for ensuring the safety and soundness of the new system.

Investments in non-financial companies should be carefully scrutinized in order to avoid potential risks for the possible deterioration of the financial condition of those companies which may affect the overall financial situation of the banks.

The MFS is emerging from one of the world's worst financial crises in the last decade. Its structure is still fragile; any profound transformation may be destabilizing. Therefore, the implementation of a UB system in Mexico should only be conducted after a careful period of consultation with all MFS participants and after the financial condition of the system as a whole has improved.

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